No. 12,803

IN THE

United States Court of Appeals

For the Ninth Circuit

FRED C. HALL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition to Review a Decision of the Tax Court of the United States.

PETITIONER'S OPENING BRIEF.

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STATEMENT OF THE CASE.

Petitioner, who before November of 1942 was the manager of the Jig and Fixture Division of The American Coach and Body Company, in Cleveland, Ohio, was one of four organizers of the Ohio Aircraft Fixture Company, a corporation organized in November of 1942 to purchase said Jig and Fixture Division from The American Coach and Body Company. (Tr. p. 35.)

The Division was taken over intact with its personnel and valuable war production contracts, on very lenient terms, so that no cash was required for the purchase, and the new concern (the Ohio Aircraft

Fixture Company, hereafter called the corporation) needed only a small amount of capital in cash as current working capital. (Tr. pp. 22, 35, 36.)

The corporation issued shares as follows:

(1) Fifty shares were issued to each of the four organizers upon the signing of certain contracts between the organizers and the corporation. The contracts, which were similar, at least insofar as material to the issues in this proceeding, provided that each of the organizers was to work for the corporation for two years for a certain salary, and an additional salary or bonus. (Tr. pp. 38, 39.)

The contracts contained miscellaneous provisions regarding the effect of death or illness on compensation, and commitments to use best efforts on behalf of the corporation, and not to engage in other gainful employment.

Each contract provided for the issuance of said fifty shares of stock to the organizer.

The petitioner's contract appears at pages 14-17 of the transcript.

In accordance with the provisions of paragraph 5 of his contract, said fifty shares of stock were issued to petitioner in 1942 as follows:

Two certificates, in petitioner's name, each for twenty-five shares, were delivered to petitioner, endorsed by him in blank, and "deposited with the Treasurer of the Company for the faithful performance of this contract." (Tr. pp. 13, 14, 19, 20, 25, 38, 39; Contract ¶5.)

Petitioner completely performed the contract, and the certificates were released to him, one in 1943, and the other in 1944, after one and two years respectively. (Tr. pp. 20, 39.)

When issued in 1942 the shares had a fair market value of $100.00 per share. (Tr. p. 39.)

Petitioner sold his shares to others of the original organizers in 1946 for $150.00 per share. (Tr. pp. 24, 39.)

The corporation has since been dissolved. (Tr. p. 24.)

Petitioner reported the shares as ordinary income in 1942 at their fair market value of $100.00 per share. (Tr. pp. 29, 30, 40.)

The Commissioner determined that the income represented by the shares was not realized in 1942, but was realized one-half in 1943 and one-half in 1944, when the certificates which had been deposited with the corporation pursuant to the contract were released to petitioner. (Tr. pp. 12, 13, 40.)

Abstract of questions presented.

Fundamentally the question presented is whether income in the form of shares in a corporation was taxable income to the petitioner in 1942 when he reported it, or one-half in 1943 and one-half in 1944, according to the Commissioner's determination, which the Tax Court has sustained.

For purposes of analysis, this question may be broken down as follows:

(1) On the basis of the facts established by the record and the application of correct legal principles thereto, what was petitioner's relation to the stock in 1942, and, more particularly, did petitioner own the stock in 1942, subject to a pledge as security for the performance of an employment contract, as he contends, or was his interest in the stock in 1942 so limited as to amount in substance merely to a right to receive stock in the future, as contended by the Commissioner?

(2) On the basis of the answer to question 1, when was the income represented by the stock realized by petitioner, a cash basis taxpayer,—in 1942, as he contends and as he reported it, or in 1943 and 1944, as determined by the Commissioner?

SPECIFICATION OF ERRORS.

Petitioner's full specification of errors appears in the transcript at pages 55-58, paragraph IV, under the heading "Points on Which Petitioner Relies", to which reference is hereby made.

Petitioner's points may be summarized as follows:

(I) The contract in question, the circumstances surrounding the issuance of the shares, and petitioner's uncontradicted and unimpeached testimony, considered in the light of established principles of corporation and security law required the Tax Court to find, and said court erred in not finding,

a. that the shares in question were issued to petitioner in 1942, and that he then became the owner thereof.

b. that petitioner's ownership of the shares in 1942 was restricted only by a pledge thereof to the corporation, as security for his performance of the contract.

(II) Established principles of corporation, security, and taxation law required the Tax Court to hold, and said court erred in not holding, that the income represented by the stock was realized and properly reported in 1942, and that there exists no tax deficiency for 1943 or 1944.

ARGUMENT.

I.

THE SHARES WERE ISSUED TO AND OWNED BY PETITIONER IN 1942, SUBJECT ONLY TO A PLEDGE TO THE CORPORATION AS SECURITY.

Because this case is essentially simple, and upon realistic analysis petitioner's position seems so clearly correct, it is counsel's desire to present the most concise argument consistent with a fair presentation of the case.

However when one moves from the contract and the transcript of the hearing to the opinion of the court, one passes from the real world down a rabbit hole to Wonderland; definite facts become clouded and elusive, and things are not what they seem. And concise discussion becomes difficult.

The controversy turns mainly on the effect of paragraph 5 of petitioner's employment contract, and acts done in performance thereof, interpreted, of course, in the light of surrounding circumstances and pertinent testimony. Said paragraph 5 provides (Tr. p. 16):

> "First Party shall issue fifty (50) shares of stock of the Company in consideration of the signing of this employment contract and to carry out certain contracts necessary in the prosecution of the war. Two certificates are to be issued. Each to be for twenty-five shares and endorsed in blank. They are to be deposited with the Treasurer of the Company for the faithful performance of this contract. One certificate for twenty-five shares to be delivered on December 1, 1943 and the other certificate for twenty-five shares to be delivered on December 1, 1944, on the order of the Board of Directors."

The court found that, pursuant to such provision, certificates for fifty shares of stock were issued in petitioner's name and in the names of each of the other three organizers, endorsed by the person named therein, and deposited with the corporation treasurer. (Tr. pp. 38, 39.)

This finding doesn't say whether petitioner's shares were issued *to him* and *pledged* by him. ("[*I*]*ssued in petitioner's name*"[1] and "He endorsed each stock certificate and deposited it with the treasurer * * *") (Tr. p. 38.) But if the shares were issued they must have been issued to petitioner and the other organ-

[1]Unless otherwise indicated, emphasis is added by counsel.

izers; a corporation can't issue shares to itself any more than a person can contract with himself.

We are further enlightened by the following:

> "The total number of shares of stock originally issued by the company was 231. Of this number, 200 shares were *issued to the organizers* upon their execution of employment contracts, and 31 were issued to the organizers upon the payment of $100.00 per share." (Tr. p. 39.)

Thus it appears from the findings of fact that the shares in question were originally—at the outset in 1942—*issued to the petitioner* upon his execution of the contract.

But we still don't know from the court's opinion what next occurred when the petitioner endorsed the shares and caused them to be "deposited with the Treasurer * * * for the faithful performance of his contract." (Contract ¶5; Tr. pp. 37, 38.) Did he pledge the certificates—was this a security transaction? Or did he "unissue" the shares?

All we find out is that "Petitioner became the unrestricted owner of 25 shares of stock in the Company in 1943 in exchange for services which he rendered to the Company in that year." (And similarly as to the other 25 shares in 1944.) (Tr. p. 40.)

We don't know what "becoming the unrestricted owner" involved—a release of the shares from a pledge made as security; perhaps, contrary to the finding that the shares were issued in 1942, an original issuance of the stock; or perhaps the removal of the corporate shares from some novel legal deep freeze

which operates to prevent issued and outstanding shares from being owned by the person to whom issued, by the corporation, or by anyone else—contracts between the corporation and the little man who wasn't there!

The resolution of this legal and factual paradox is not difficult; either (1) the shares were issued to and owned by the petitioner in 1942, and the certificates representing his shares were pledged by him to the corporation as security for the performance of his contract, or (2) the shares were not issued at all, and the petitioner merely had a right to have shares issued to him in the future, on certain conditions.

Fact and law unite to demonstrate that the first of the above alternatives is the correct and only tenable conclusion.

A.

FUNDAMENTALS OF CORPORATION AND SECURITY LAW ESTABLISH THAT THE SHARES WERE ISSUED TO AND OWNED BY PETITIONER IN 1942, AND PLEDGED BY HIM TO THE CORPORATION.

Before further analysis of the facts, it may be helpful to touch briefly on the law which imparts to those facts their true legal significance.

1. Petitioner became the owner of the shares immediately upon the execution of the contract.

Paragraph 5 calls for the *issue* of 50 shares of stock. It is fundamental corporation law that the issue of stock means the formation of a share contract between shareholder and corporation. Such a contract must have two parties. A corporation cannot issue

shares to itself. The issue of stock by a corporation makes the other party to the issue contract a shareholder and an owner of shares. The share certificates are mere evidence of the shareholder relation and are not essential to its creation.

Professor Henry Winthrop Ballantine states:

> "Shares of stock are contracts issued or created by mutual assent of the corporation and the shareholder * * * The word 'issue' is generally employed to indicate the making of a share contract, that is, transactions by which a person becomes the owner of shares and by which new share contracts are created. The word 'issue' is often associated with the execution and delivery of a share certificate but the issue of shares is not dependent on the delivery of a certificate for the shares. A person may become the owner of shares in a corporation either by subscription or the original issue of shares by agreement with the corporation * * *"
>
> *Ballantine on Corporations* (Rev. Ed. 1946), Section 199, pp. 466, 7.

To the same effect:

> 11 *Fletcher, Cyclopedia Corporations* (Perm. Ed.), Sections 5155, 5159.

As a matter of realistic interpretation of the contract in the light of fundamental corporation law it is submitted that petitioner intended to become and became a shareholder upon the signing of the contract, or at the latest, when the certificates made out in his name were delivered to him for endorsement. Although the term "shall issue" could indicate a future

issue, the only provision as to time of issue is "in consideration of the signing of this employment contract * * *"; the contract clearly indicates that an immediate issue of shares to petitioner was intended.

The provisions respecting certificates, though apparently regarded as defining the manner in which the shares were to be issued, are, as a matter of corporation law, not essential to the issuance of stock. However, the contract goes on to provide for the issue of certificates and their endorsement in blank by petitioner. It was stipulated (Tr. pp. 13, 14) and proved by testimony (Tr. pp. 19, 20, 25) that these things were done (i.e., that shares were issued to Mr. Hall and that the certificates representing them were delivered to and endorsed by him) in 1942. That is to say, respondent stipulated that petitioner became a shareholder of the 50 shares in question in 1942.

It is difficult for petitioner's counsel to see what remains to be argued after that stipulation. Assume for a moment that the positions of the parties were reversed, and that petitioner, instead of defending his inclusion of the shares in his 1942 return, was attempting to justify his failure so to report the transaction. The court may judge the success which petitioner would have in maintaining the position that the shares did not constitute income in 1942, in the face of a stipulation and uncontradicted and unimpeached testimony that they had been issued to and endorsed by him in that year.

2. The contract shows that a pledge was intended; a pledgor is the substantial owner of pledged property.

The phrase "deposited * * * for the faithful performance of this contract" makes it unmistakably clear that paragraph 5 contemplates a security transaction and is not a provision deferring the issuance of shares to petitioner, or petitioner's ownership of the stock in question, until the redelivery of the certificates. In a word the paragraph provides for a pledge. It is equally clear that a pledgor of stock is the owner thereof, subject only to whatever rights are given to the pledgee by the pledge contract, as interpreted in the light of the law respecting pledges.

A physical transfer of share certificates intended as security will be treated as a pledge, and contractual provisions to defeat the pledgor's ownership, e.g., provisions purporting to give absolute ownership or control to the pledgee, will be held invalid, under the public policy that provisions clogging the right of redemption are void.

Therefore the last sentence of the share issue and pledge provisions (Contract, ¶5) providing for the certificates being released to petitioner on designated future dates "on the order of the Board of Directors" can only be regarded as mechanical provisions governing termination of the pledge, and not as a clog on or condition precedent to petitioner's ownership of the shares. (Of course a pledgee must in the first instance determine whether the secured obligation has been performed, but his determination thereof cannot deprive the pledgor of his property, except through legal foreclosure proceedings.)

In *Hawley v. Hawley* (C.A.D.C. 1940), 114 F. (2d) 745, shares had been transferred under an agreement showing that a security transaction was intended. A clause providing clearly that the stock would become the transferee's property on failure to pay the obligations secured was held to be of no effect. The court quoted from *Haselden v. Hamer* (1914), 97 S.C. 178, 184, 81 S.E. 424, 425: "The pledgee is not entitled upon the pledgor's default to take the property as his own in satisfaction of the debt. A provision in the contract by which the absolute property is to vest in the pledgee upon the default of the pledgor is void * * *" It went on to declare correctly that this is a universally accepted rule, citing annotation 24 A.L.R. 822.

Regardless of what designations may be technically most appropriate for describing the respective rights of pledgor and pledgee, it is clear that the pledgor retains the general property in and ownership of the property pledged, and the pledgee receives but a special property right only extensive enough to provide security for the obligation secured. For example a pledgor may transfer the pledged property, subject, however, to the pledge.

Brightwell v. First National Bank of Kissimmee (C.C.A. 5th, 1940), 109 F. (2d) 271.

In *Lawrence v. I. N. Parlier Estate Co.* (1940), 15 Cal. (2d) 220, the court discusses generally the consequences of pledging stock in a corporation to that corporation.

As far as time of realization of income is concerned it is difficult to see how the transaction would have

been different had the contract provided for issuance to petitioner of Ohio Aircraft Fixture Company stock, and for petitioner to deposit as security for performance, General Motors stock, or even a diamond ring. The tax consequences of the issuance of stock should not be altered because that stock, instead of something else of similar value, has been made security for performance of the contract under which the stock was issued.

It is hoped that the foregoing brief review of applicable legal principles is sufficient to show that *if* the parties intended an immediate share issue and *if* they intended a deposit as security, the result would be that in 1942 petitioner was a shareholder and the owner of the shares in question, his ownership being restricted only by the valid terms and legal incidents of the pledge provisions.

What, then, are the facts?

B.

THE CONTRACT, THE CIRCUMSTANCES SURROUNDING THE TRANSACTION, AND PETITIONER'S DIRECT, UNCONTRADICTED, AND UNIMPEACHED TESTIMONY COMBINE TO DEMONSTRATE THAT AN IMMEDIATE ISSUE AND PLEDGE AS SECURITY WAS INTENDED AND EFFECTED.

1. The contract on its face compels one to conclude that petitioner became a shareholder in the Ohio Aircraft Fixture Company in 1942.

In addition to ¶5 quoted and discussed above, the contract, set forth in full at Transcript pp. 14-17, provided in substance as follows:

¶1. Petitioner was to manage a department of the Ohio Aircraft Fixture Company for two years.

¶2. He was to exert his best efforts, skills, and abilities for the profit of the company.

¶3. As compensation for his services he was to receive a salary of $125.00 per week, plus ten per cent of corporate profits, part of the weekly salary and all of the percentage of profits being payable in stock at the option of the company.

¶4. In the event of disabling illness, the weekly salary was to continue in full for six months, at one-half for the following six months, and at one-quarter for the remaining duration of the contract; petitioner's additional salary (the percentage of profits) was to continue unaffected, even though illness prevented him from rendering the services provided in the contract.

¶5. Quoted at page 6, supra.

¶6. Petitioner covenanted not to engage, for the duration of the contract, in any other gainful occupation without consent of the Board of Directors.

¶7. The contract was to be considered performed on death of the petitioner.

Clearly the contract contemplated the immediate present issuance of stock to petitioner—the present creation of the status of shareholder—and the pledge of such stock as security for the performance of the contract.

This construction is indicated by the stated consideration for the share issue. (¶5, p. 6, supra.) "* * * the signing of this employment contract and to carry out certain contracts necessary in the prosecu-

tion of the war." This language shows the consideration for the issuance of shares—"the signing of this employment contract"—and the corporate purpose to be achieved thereby—the securing of petitioner's undertaking to perform duties necessary to carry out the war contracts referred to. If there is any ambiguity on this score, it is resolved by testimony of the petitioner. (Tr. pp. 25, 26.)

Obviously, he was not receiving the shares in return for services to be rendered because the shares were to belong to him even though his death (¶7) or his illness (¶4) prevented him from rendering services. Furthermore, he was to be paid a regular salary for rendering services, and an additional salary or bonus of a percentage of profits, also as compensation for services. (¶3.) This in itself was an incentive compensation arrangement; and because part of the regular and all of the additional salary were payable in stock, at the company's option, it also served as a stock-bonus type of incentive plan.

Why, then, did the contract provide that stock was to be issued to petitioner at the outset? The only fair answer, based on the contract itself, is, *to make him a shareholder at that time.*

Perhaps he would not have come into the enterprise at all unless he was to be a substantial shareholder from the start. Regardless of the terms of bargaining, which are not known, the bargain made, calls, in terms, for him to be made a shareholder immediately.

2. **The circumstances surrounding the transaction compel one to conclude that petitioner became a shareholder in the Ohio Aircraft Fixture Company in 1942.**

Petitioner was one of four promoters or organizers of the company in question, the Ohio Aircraft Fixture Company. (Tr. pp. 18, 35.) Because he was and had for some time been the manager of the Jig and Fixture Division of The American Coach and Body Company, which division was to become the entire business of the Ohio Aircraft Fixture Company (Tr. pp. 18, 35), the assured continuation of his services was obviously of great importance to the new concern. The organization took place early in the war, when the services of personnel skilled and experienced in management of war production operations were of great value. The record does not show, nor does it appear important, exactly what the relative contributions of petitioner and the other organizers were. It does appear that each organizer received fifty shares of stock on executing an employment contract, and that the other three each bought ten shares for cash at $100.00 per share, whereas petitioner purchased only one share for cash. (Tr. pp. 21, 35.)

It further appears that the new company had little need for capital because it took over a going concern (the Jig and Fixture Division which petitioner had been managing) on very lenient terms, and also took over valuable war production contracts. (Tr. pp. 22, 35, 36.)

Clearly, petitioner was a key man, of sufficient importance to enter the new concern as nearly a one-

fourth owner, without the investment of any substantial amount of cash.

Petitioner submits that under these circumstances, the contract between him and the corporation and similar contracts of the other promoters clearly establish the intention of all the organizers and of the corporation, which was their creature, that they should all, from the outset, be the shareholders of the corporation.

It does not make sense that the promoters and organizers of such an enterprise should not be substantial shareholders from the outset. It does not make sense that petitioner would not insist, in exchange for his contribution to the establishment of the new enterprise, on being a shareholder from the outset. If the shares were issued for services, the services were his past efforts as a promoter, not future work as an employee.

3. Petitioner's uncontradicted and unimpeached testimony, fully corroborated by the contract and the surrounding circumstances, shows that he became a shareholder in 1942.

Petitioner testified that the shares were issued in his name; that the certificates made out in his name (Tr. p. 19) were actually delivered to him (Tr. p. 19), endorsed by him (Tr. p. 20), and deposited as security, in accordance with the contract.

In response to questions of the court he testified that the shares were issued to him in 1942 (Tr. p. 25) and that they were issued as an incentive to him to leave his old job and undertake the responsibility of

completing contracts being taken over with the business. (Tr. p. 23.)

To questions of the court regarding the contract, especially paragraph 5, he testified that prior to the signing of the contract it was agreed that *he was to receive fifty shares of stock for signing the contract,* and was to endorse the certificates back to a prescribed officer of the company. (Tr. p. 25.)

The court asked petitioner his understanding of the provision requiring him to endorse the certificates and return them to the treasurer of the company. (Tr. p. 26.)

Petitioner referred to the responsibility the company had for carrying out certain war contracts, and stated his understanding to be that if he failed to perform his contract he would need to be replaced, and that expenses or damages resulting from his failure to perform or his replacement could be recovered from the stock which had been issued to him and deposited with the company. (Tr. p. 26.)

This is exactly what the contract, in terms and in legal effect, provides. It is consistent with and realistic in view of the circumstance that he was one of the four organizers of the company—one of four men who were able to take over a going war-production business in 1942, not by investment (for the $3,100 cash investment was to provide working capital (Tr. pp. 21, 22), not a down or partial payment on the purchase of assets, for which purpose it is clearly ridiculously small), but simply by agreeing to manage it, and see that the lenient terms of purchase were met.

The corporation was clearly a device by which the four organizers acquired ownership in 1942 of the Jig and Fixture Division of The American Coach and Body Company.

A conclusion that petitioner was not the owner of the stock in 1942 can only be reached by ignoring his testimony—testimony entirely consistent with and corroborated by the contract and the surrounding circumstances, and free from impeachment and contradiction.[2]

Perhaps more important, petitioner's affirmative and unequivocal act in reporting the value of the stock as ordinary income for 1942 shows that, as he then understood the transactions involved, he had received the shares in 1942, and then owned them.

The united, consistent, mutually supporting forces of the contract, the factual context of the transactions involved, petitioner's testimony, and petitioner's conduct, show to the point of demonstration that petitioner became the owner of the shares in 1942 and that he then pledged the certificates as security for the performance of his contract.

It has seemed necessary to belabor the point because of the decision of the Tax Court herein; however, there appears in fact to be no real question,

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[2]It seems clearly established that uncontradicted unimpeached testimony which is not inherently improbable nor inconsistent with established facts and circumstances must be accepted by the Tax Court and cannot be arbitrarily disregarded. *Grace Bros. v. Commissioner* (C. A. 9th, 1949), 173 F.(2d) 170, at 174; see also, *J. H. Robinson Truck Lines v. Commissioner* (C. A. 5th, 1950), 183 F. (2d) 739, at 740, and cases there cited.

because it was stipulated (Tr. pp. 13, 14) and seemingly found (Tr. pp. 38, 39) that the shares were issued to petitioner in 1942.

Effect of Ohio statutory provisions respecting consideration for shares.

Although respondent's answer contains nothing suggesting that invalidity of the shares under provisions of local law was to be relied on; although respondent stipulated that the shares were issued, which must mean validly issued, in 1942; although the question of validity under Ohio law was in no way raised or suggested at the hearing; although the effect of Ohio law was not urged by respondent in briefs; although the Tax Court's findings show a share issue to petitioner and the other organizers in 1942, and although no findings of fact were made regarding conformity of the issue to requirements of Ohio law (necessarily so, for the matter was not tried, and the record contains no evidence directed to that issue, and no evidence sufficient to support a finding of invalidity), the Tax Court relied as a supporting ground for its decision on an argument to the effect that the shares weren't issued in 1942 because they couldn't have validly been so issued under Ohio law. (Tr. pp. 46, 47.)

Reliance on this ground was improper, as a matter of procedure; in addition on the merits thereof the argument is incorrect as a matter of law.

Tax Court Rule 14 requires that "* * * The answer shall be so drawn as fully and completely to advise the petitioner and the Court of the nature of the defense. It shall contain a specific admission or denial

of each material allegation of fact contained in the petition and a statement of any facts upon which the Commissioner relies for defense or for affirmative relief * * *"

This rule was recently applied in *Sangstrom Hettler* (Feb. 28, 1951), 16 T.C. #65, pointing out that an issue must be raised by proper pleading, or at least by sufficient indication during the trial. See also *William F. Horsting* (1946), 5 T.C.M. 421; *Wentworth Manufacturing Co.* (1946), 6 T.C. 1201. This is obviously essential to fair judicial procedure, for as will be apparent from the slightest glance at the authorities, e.g., the two hundred or more pages devoted by Fletcher, 11 *Cyclopedia Corporations*, §§ 5182-5257, to the subject of consideration for shares and the effect of a purported issuance for unauthorized consideration, the subject is complex, and particular facts and circumstances are important.

The determination of an issue adversely to the taxpayer, partly on the basis of such an issue as to which he had opportunity neither to present evidence nor argument, cannot be justified.

It is petitioner's hope that an analysis of the complex law on this subject will not be necessary; on the basis of a reasonably comprehensive examination of the pertinent authorities, petitioner's counsel have concluded that the Ohio statutory provisions relied on by the Tax Court did not have the effect of preventing the shares from being validly issued in 1942, in accordance with the manifest intention of the parties.

Though shares so issued would in many circumstances be subject to attack by shareholders who did not knowingly acquiesce in the transaction, and by the corporation acting on behalf of such shareholders or of creditors, and although creditors, in the event of insolvency, might have been able to hold petitioner to payment in cash of the $100 per share established by the directors as the value and contribution to capital represented by the shares, in the circumstances of this case, as between petitioner and the corporation, and the other organizers and shareholders, the shares were, from the outset in 1942, validly issued to and outstanding in the ownership of petitioner.

Certainly the shares and the transactions in which they were issued, are not now subject to question in this entirely collateral proceeding.

Professor Ballantine, in his *Law of Corporations,* § 351, pp. 808-812, discusses statutes of the Ohio type and clearly indicates that they do not have the effect of invalidating shares issued for unauthorized consideration.

II.

THE SHARES CONSTITUTED INCOME TO PETITIONER IN 1942.

The purported factual basis for the conclusion that the shares did not constitute income for 1942 is that petitioner did not then become the "unrestricted owner" of the shares. Of course he did not become the unrestricted owner of the shares then; they were issued under a contract that required that they be

pledged, and they were pledged, pledged as security for the performance of the contract.

So, he didn't become the "unrestricted owner" in 1942. The fact that property *actually received* by a taxpayer is subject to restrictions limiting his ownership, use or control thereof, does not prevent it from being immediately taxable as income. *Soreng v. Commissioner* (C.C.A. 7th, 1946), 158 F. (2d) 340. Cf. *Standard Slag Co. v. Commissioner* (C.A.D.C. 1933), 63 F. (2d) 820.

An attempt has been made to discover the source of confusion underlying the Commissioner's case; it appears to arise from the failure of both Commissioner and Tax Court to appreciate fundamental distinctions between income in the form of money and income in the form of property other than money, and between constructive receipt of money (or perhaps in rare cases of other property) and actual receipt of property other than money.

If the income in question is cash, and it has not come into the taxpayer's possession, he has not actually received the only thing in issue—the money.

If, though not actually received by reduction to possession, the money is subject to the taxpayer's unrestricted control and domination, or applied for his benefit, it is not reasonable that taxation be postponed or prevented by the taxpayer's omission to collect it or reduce it to possession, and in such cases the money is immediately taxed under the doctrine of constructive receipt.

However, the doctrine of constructive receipt is intended to reach income actually available to the taxpayer, and is accordingly applied only to income which is unqualifiedly subject to his command—available to him without restriction.

Thus many of the cases relied on by the Tax Court hold that income in the form of money was not *constructively received* because it was subject to such restrictions that the taxpayer did not have command over it or the immediate right to reduce it to possession. *Marion H. McArdle* (1948), 11 T.C. 961; *E. P. Madigan* (1941), 43 B.T.A. 549; *International Mortgage and Investment Co.* (1937), 36 B.T.A. 187; *Preston R. Bassett* (1935), 33 B.T.A. 182; *Benjamin F. Patterson* (1930), 21 B.T.A. 8. (Cf. *Cleveland-Trinidad Paving Co.* (1930), 20 B.T.A. 772.)

But we are not dealing here with the question of whether or not the income in question was constructively received in 1942.

How does a taxpayer *actually receive* income in the form of shares in a corporation? How else but by the creation of the share contract with the corporation—by having the shares issued to him, and becoming the owner of such shares, and a shareholder in the corporation?

If these things occurred in 1942, *the shares were actually then received,* and the existence of restrictions which might, in the case of money, prevent application of the doctrine of *constructive* receipt, is of no consequence.

The distinction between income in stock and in money is illuminated, and the soundness of petitioner's position is demonstrated, by a comparison of *Luther Bonham* (1936), 33 B.T.A. 1100, affirmed *Bonham v. Commissioner* (C.C.A. 8th, 1937), 89 F. (2d) 725, and *Marion H. McArdle, supra,* heavily relied on by the Tax Court herein.

Luther Bonham, at 1105, 1106:

> "The only remaining question to be determined is whether or not the petitioner, being on a cash receipts and disbursements basis, received in the taxable year the 750 shares of the Northwest Bancorporation stock covered by paragraph 4 of the contract. If so, this stock, at $70 per share, must also be included in computing the gain recognized for the year 1929.
>
> "The petitioner contends that never at any moment until this stock was released to him in 1931 and 1932 did he receive it or have a right to receive it, and that under no circumstances did it constitute income to him in any prior year.
>
> "The contract between the parties best reflects the actual transaction. By its terms the petitioner and his wife disposed of 750 shares of bank stock and received therefor 2,250 shares of stock of the Northwest Bancorporation and $67,500 in cash. In section 4 of the contract, it appears that the company had questioned certain paper carried in the assets of the bank, and the 750 shares of stock were deposited with the company and were to be held by it until the actual work-out of these assets had been determined. According to the terms of the contract the peti-

tioner and his wife received the entire amount of the stock in the year 1929 and deposited the 750 shares as security for the representations made by them with reference to the assets of the bank. (Citations.) In the last two cases cited stock was sold for cash and it was pointed out in the opinions that the sellers did not receive in the taxable year the full amount of the purchase price, nor did they have the right to receive it. Payment of this balance was conditional and it was held that such balance did not constitute income until the events on which payment was conditioned were fulfilled. This case is different. Here the contract contained no condition whatever with reference to the payment of the full amount of the stock agreed upon. Even though the assets of the bank did not work out as represented, there was no right on the part of the seller to reduce the number or to take back any of the shares exchanged under the contract, but only a right to sell collateral to the extent required to make good the representations as to the bank assets. *Ownership of this stock had passed to the petitioner and he was exactly in the same situation as if other securities had been deposited in the place of the 750 shares of company stock.*"

In affirming the determination that the gain was taxable in 1929, the Eighth Circuit Court of Appeals said:

"* * * [the contract] required the issue of 750 shares of the Northwest stock; the 'deposit' thereof with that company until fulfillment of the conditions of Exhibit B; and the right to 'sell * * * on the market' such stock or parts thereof

as necessary to make good default in such fulfillment. Such requirements are consistent only with the passing of title to the stock and its pledge as guarantee of fulfillment of the conditions of Exhibit B. The stock was issued, the title passed then to petitioner, and the stock was retained as a pledge. The circumstance is unimportant that the stock was not physically delivered to petitioner and then redelivered by him to the company upon the pledge. In so far as strict legal right under the contract is concerned, he might have demanded such delivery and have made such redelivery. The actual handling through issuance and retention on the pledge was merely a matter of convenience not of legal right."

The court, recognizing that the transaction could have been set up so as to postpone realization of the gain, by use of a contract to issue the shares in the future instead of a present issue and pledge back as security, pointed out that where such alternatives are available, for example, as to the time of passage of title to stock, both taxpayer and government are bound by what was done, and the tax consequences are not affected by what might have been done.

In the present case, as in the *Bonham* case, the shares were issued and pledged at the outset of the transaction.

In the *McArdle* case, *supra,* in which it was held that payments in the form of cashiers' checks representing part of the purchase price of stock, which were, pursuant to agreement, delivered to a seller,

endorsed by him, and returned to the buyer as security against contingent liabilities, did not represent income to the taxpayer in the year so delivered and endorsed, the Tax Court discussed the *Bonham* case, as follows:

> "The parties apparently recognize that *Luther Bonham,* 33 B.T.A. 1100 * * *, affirmed 89 Fed. (2d) 725 is distinguishable, at least they have not cited it. There the taxpayer received some stock which he was required immediately to put up as collateral. But it was his stock and he had the rights of ownership of it such as the voting rights, dividend rights, the right to any increase in value, and the right to have that particular stock returned to him when the collateral was no longer required."

If any doubts remain as to the correctness of petitioner's position, they should be allayed by the decision of this court in *Chaplin v. Commissioner* (C.C.A. 9th, 1943), 136 F. (2d) 298, reversing *Charles Chaplin* (1942), 46 B.T.A. 385.

The principal issue was whether Charles Chaplin, one of the organizers of United Artists Corporation, realized income in the form of shares of the corporation in 1935 when they were delivered to him by an escrow holder pursuant to instructions from the corporation that Chaplin had satisfied his obligations under the agreement, as modified, under which the shares were originally issued.

This court examined the pertinent documents and considered the conduct of the parties.

It quoted and applied the following rule (p. 301):

> "It is elementary that title passes when the parties intend that it shall pass and such intention is to be gathered from the contract and conduct of the parties."

After analyzing the facts in the light of this rule, the court concluded (p. 302):

> "We consider the agreement of 1924 controls the prior agreements, none of which explicitly defined the place of ownership. Under that agreement the shares are owned by the artist as appeared on the certificates held by the escrow agent, whose only power, like that of a pledgee, was to transfer them to United if Chaplin failed to perform his contract. One nonetheless owns personal property because held by another to insure the performance of a contract.
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> "We hold that Chaplin owned the common shares at least since 1928, when he received and endorsed the certificates thereafter held by O'Brien; that the Tax Court erred in including their value in his 1935 income."

Though the present case does not exactly parallel the *Chaplin* case as to all material facts, the similarity is striking, and the ultimate fact that the parties intended that title to the shares pass at the time of issuance, endorsement, and delivery as security, rather than on their release from deposit as security, is identical.

The observation of the learned Tax Court judge (Tr. p. 49) in connection with the discussion of

Anthony Schneider (1926), 3 B.T.A. 920, that *Charles Chaplin, supra,* was "reversed on another issue" by this court, is indicative of confusion in the analysis of applicable law and authority.

On the issue of the time of realization of income in the form of shares of stock, the Board of Tax Appeals decision in *Charles Chaplin,* conformed to the views of the board in *Anthony Schneider,* and, on precisely this issue, it was reversed.

The Tax Court's asserted difficulty in understanding the pertinency of this court's decision in the *Chaplin* case (Tr. p. 49) is surprising. Some point is made that the consideration for the shares was to be property in the form of photoplays, rather than the personal services of Charlie Chaplin. Of course there is more to a finished photoplay than the personal services of the star, but obviously the real consideration was his unique personal talent—or perhaps his contract would have been equally performed had he delivered a movie starring King Kong!

In any event the nature of the consideration rendered or to be rendered in exchange for stock or the time of rendering it is not material. Money or property constituting income is taxable when received, even though in exchange for services to be rendered in the future. *Allen v. Commissioner* (C.C.A. 4th, 1939), 107 F. (2d) 151 (stock for future legal services; cash basis taxpayer); *Your Health Club, Inc.* (1944), 4 T.C. 385 (money received for club services to be furnished in future; accrual basis taxpayer).

Another point made in the opinion is that petitioner did not prove receipt of dividends, or exercise of voting rights. (Tr. pp. 43, 50.) He proved issuance and ownership of the stock, from which dividend and voting rights follow, absent proof to the contrary. Respondent had no evidence or cross-examination questions on these issues.

The underlying confusion between property and money as income and between actual and constructive receipt is again demonstrated by the Tax Court's observations on the dividend issue involved in the *Chaplin* case. (Tr. p. 50.)

Of course cash dividends paid to the escrow holder and subject to the restrictions of the escrow were not sufficiently subject to Chaplin's control and domination to be substantially equivalent to cash reduced to his possession, and therefore were not constructively received by Chaplin prior to actual distribution to him, and this court so held. This is not inconsistent with, and indeed has nothing to do with, the proposition that shares of stock issued and deposited as security are income when originally issued.

Reference may also be made to the following additional authority supporting petitioner's contentions. Income arising by virtue of the creation of the shareholder relationship is realized in the year the relationship is created, despite failure to issue certificates, *Bradbury v. Commissioner* (1931), 23 B.T.A. 1352; and regardless of the fact that ownership is restricted by a security device, e.g., an escrow, *Carnahan v. Commissioner* (1930), 21 B.T.A. 893; *Cohu v. Com-*

missioner (1947), 6 T.C. 796; cf. *Moore v. Commissioner* (C.C.A. 7th, 1941), 124 F. (2d) 991.

COMMENT ON OTHER AUTHORITIES.

The cases of *Schneider v. Duffy* (D.C.N.J. 1930), 43 F. (2d) 642, relied on by petitioner, and *Anthony Schneider* (1926), 3 B.T.A. 920, relitigated with the same result reached by the Tax Court in *Glen v. Bowers* (D.C.N.Y., S.D., 1932) (no opinion); affirmed without opinion (C.C.A. 2nd, 1933), 65 F. (2d) 1017, cert. den. (1933), 290 U.S. 681, relied on by respondent and by the Tax Court, considered identical contracts and fact situations, with opposite, and of course irreconcilable, results. Petitioner submits that the opinion in *Schneider v. Duffy,* shows much superior factual analysis and legal reasoning than the Board's opinion in *Anthony Schneider.*

Petitioner has carefully analyzed the remaining cases relied on or cited by the Tax Court involving income in the form of stock which can be regarded as remotely in point (cf. *Charles F. Mitchell* (1941), 45 B.T.A. 300; *K. E. Merren* (1929), 18 B.T.A. 156) and finds them uniformly distinguishable, none involving an actual stock issue and pledge back as security.

The remaining cases involving income in the form of stock are, in the order cited in the opinion: *Charles F. Mitchell* (1941), 45 B.T.A. 300 (Tr. p. 42); *Phillip W. Haberman* (1934), 31 B.T.A. 75, affd. 79 F. (2d) 995 (Tr. p. 44); *Lyle H. Olson* (1931), 24 B.T.A. 702

(aff'd. C.C.A. 7th, 1934), 67 F. (2d) 726, cert. den. 292 U.S. 637 (Tr. p. 44); *Adolph Zukor* (1935), 33 B.T.A. 324 (Tr. p. 45); *Roscoe H. Aldrich* (1926), 3 B.T.A. 911 (Tr. p. 45); *Charles F. Pearce* (1927), 6 B.T.A. 450 (Tr. p. 45); *James R. Lister* (1926), 3 B.T.A. 475 (Tr. p. 45); *K. E. Merren* (1929), 18 B.T.A. 156 (Tr. p. 49); *Albert R. Erskine* (1932), 26 B.T.A. 147 (Tr. p. 49).

The following noted points of distinction are illustrative only. Detailed analysis of the cases would require an extensive, expensive, and seemingly unwarranted addition to the brief.

In most of the cases, time of realization of income was not the principal issue, *Philip W. Haberman, Lyle H. Olson, Albert R. Erskine,* or was not even in issue, *Adolph Zukor, Roscoe H. Aldrich.* (Cf. *Charles F. Pearce,* in which the amount of a stock bonus was not determinable until after the taxable year in question.)

The *Haberman* and *Erskine* cases involved *rights to purchase* stock in the future, and thereupon become a stockholder.

In *Lyle H. Olson,* estoppel was relied on, the taxpayer having failed to report the shares as income in the year he argued to be proper.

In *James R. Lister,* the contract was regarded as contemplating a future transfer of stock, conditioned on completion of three years' services, and apparently no contention was made that the income was realized at the time the contract was executed.

Petitioner respectfully submits that the decision of the Tax Court herein is clearly erroneous, and should be reversed, with directions to enter decision for the petitioner.

Dated, San Francisco, California,
April 9, 1951.

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